

Message Text

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C O R R E C T E D C O P Y (PARA 1 LINE 10)

PASS TREASURY, FEDERAL RESERVE, COMMERCE

E.O. 11652: N/A

TAGS: EFIN, FR

SUBJECT: GOF EXCHANGE RATE POLICY AND THE OUTLOOK

FOR THE FRANC IN 1976

1. SUMMARY: FRENCH EXCHANGE RATE POLICY IS DESIGNED TO SUSTAIN A RELATIVELY STRONG FRANC, I.E., A MIDDLE OR MIDDLE HIGH POSITION IN THE EC "SNAKE". THIS POLICY FACES THREE CHALLENGES IN 1976: (A) POSSIBLY EXCESSIVE INFLATION IN TERMS OF OTHER MAJOR INDUSTRIAL COUNTRIES: (B) THE EMERGENCE OF A LARGE TRADE DEFICIT; AND (C) SERIOUS FRENCH CORPORATE CASH FLOW AND PROFIT PROBLEMS. ON BALANCE, PRESENT EXCHANGE RATE POLICY PROBABLY CAN BE IMPLEMENTED IN 1976. THIS MEANS A FRANC/DOLLAR RATE IN THE 4.40 TO 4.60 RANGE, GIVEN THE PRESENT AND

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WHAT THE FRENCH AUTHORITIES BELIEVE TO BE THE PROSPEC-

TIVE ARRAY OF EXCHANGE RATES AMONG THE MAJOR CURRENCIES.
END SUMMARY.

2. FRENCH MONETARY AUTHORITIES ARE VERY AWARE THAT THE SITUATION FROM 1974-II THROUGH 1975-III WAS AN UNUSUAL AND TEMPORARILY FAVORABLE SITUATION FOR FRANCE'S EXTERNAL ACCOUNTS. BOTH GLOBAL BUSINESS CYCLE DEVELOPMENTS AND LEADS AND LAGS WERE WORKING IN FAVOR OF A FRENCH TRADE SURPLUS ALMOST REGARDLESS OF THE LEVEL OF TRADE. AT THE SAME TIME RELATIVELY HIGH INTEREST RATES PLUS BORROWINGS DIRECTED BY THE AUTHORITIES TO INTERNATIONAL CAPITAL MARKETS CAUSED VERY LARGE CAPITAL INFLOWS. AS A RESULT THE FRANC APPRECIATED AGAINST THE FIELD THROUGHOUT THIS PERIOD. GIVEN THE ATTENTION BEING PAID AT THAT TIME TO ANTI-INFLATIONARY MEASURES, THE APPRECIATION OF THE FRANC WAS A WELCOME DEVELOPMENT. IN HIS NATIONWIDE TV SPEECHES ON THE ECONOMY DURING THIS PERIOD, GISCARD INVARIABLY MENTIONED A STRONG FRANC AS A SIGN OF THE STABILITY AND UNDERLYING STRENGTH OF THE ECONOMY. IT ALSO WAS AN IMPORTANT ELEMENT OF THE FIGHT AGAINST INFLATION, IN REAL AS WELL AS PSYCHOLOGICAL TERMS. HISTORICALLY THE FRENCH TEND TO ASSOCIATE GOOD TIMES WITH PERIODS OF STABLE CURRENCY. ALSO THEY HAVE PROVEN UNDER CERTAIN CIRCUMSTANCES, INCLUDING EXCESSIVE INFLATION, PRONE TO CAPITAL FLIGHT. WHILE 1975 COULD HARDLY BE CONSIDERED THE BEST OF TIMES, AT LEAST GISCARD WAS ABLE TO SAY THAT THE FRANC WAS BOTH STRONG AND STABLE AND THIS PROBABLY HAD THE DESIRED EFFECT.

3. THE DECISION TO REJOIN THE EC "CURRENCY" SNAKE REINFORCED INDEED COMMITTED THE FRANC TO A RELATIVELY STRONG POSITION. IN POLITICAL TERMS ITS MESSAGE WAS THAT THE FRANC WOULD REMAIN STABLE DESPITE ECONOMIC DIFFICULTIES. IT ALSO MEANT THAT REFLATIONARY MEASURES WOULD BE TAKEN WITHIN CERTAIN FAIRLY RESTRICTIVE PARAMETERS. INDEED THE ECONOMIC SUPPORT PROGRAM WAS VERY CAREFULLY DESIGNED IN MONETARY TERMS. TAKING 1975-III THROUGH 1976-III, ITS MONETARY EFFECTS WILL BE VIRTUALLY NEUTRAL.

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4. FOR ALL THESE REASONS IT IS EVIDENT THAT FRENCH EXCHANGE RATE POLICY IS DESIGNED TO KEEP THE FRANC RELATIVELY STRONG. THIS MEANS MAINTAINING A MIDDLE OR MIDDLE HIGH POSITION IN THE EC CURRENCY "SNAKE". THE MARKET OPERATIONS OF THE BANK OF FRANCE IN RECENT MONTHS CLEARLY HAVE HAD THIS OBJECTIVE IN MIND. THE FRENCH AUTHORITIES BELIEVE THAT THIS POLICY MEANS A

FRANC/DOLLAR RATE WITHIN THE 4.40 TO 4.60 RANGE,
GIVEN THE CURRENT AND WHAT THEY BELIEVE TO BE THE
PROSPECTIVE ARRAY OF EXCHANGE RATES AMONG INDUSTRIAL
COUNTRIES. THE "SNAKE" BEING AN UNUSUAL CREATURE,
ALSO HAS ATTRIBUTES OF AN ACCORDIAN SINCE IT CAN BOTH
STRETCH AND CONTRACT. NO MATTER HOW THE "SNAKE"
ITSELF MOVES THE FRENCH WANT VERY MUCH TO BE
NEAR THE MIDDLE, PREFERABLY SLIGHTLY ABOVE RATHER
THAN BELOW DEAD CENTER.

5. THERE ARE THREE POSSIBLE ECONOMIC DEVELOPMENTS IN
THE FRENCH ECONOMY THAT COULD CAUSE PROBLEMS FOR FRENCH
EXCHANGE RATE POLICY. THEY ARE: (A) AN EXCESSIVE
INFLATION RATE IN TERMS OF OTHER INDUSTRIAL COUNTRIES,
ESPECIALLY THOSE IN THE EC; (B) THE EMERGENCE OF A
LARGE TRADE DEFICIT; (C) CONTINUED PRESSURES ON
CORPORATE CASE FLOW AND PROFITS IN FRENCH INDUSTRY.
THERE ARE OF COURSE MANY OTHER HAZARDS -- ECONOMIC,
SOCIAL, POLITICAL, AND INTERNATIONAL -- THAT DERIVE
FROM LIVING IN A HAZARDOUS WORLD, BUT THIS REPORT
WILL LIMIT ITSELF TO THOSE HAZARDS WHICH INVOLVE
CURRENT FRENCH ECONOMIC POLICY.

6. AS FOR THE INFLATIONARY HAZARD, GOF MONETARY AND
FISCAL POLICY, DESPITE THE ECONOMIC SUPPORT PROGRAM,
REMAINS FUNDAMENTALLY AIMED TOWARD REDUCING INFLATION.
THERE ARE FORMIDABLE STRUCTURAL PROBLEMS IN THE FRENCH
ECONOMY THAT ARE INHERENTLY INFLATION PRONE, E.G.,
INDEXED RENTS, WAGES, SERVICES, AGRICULTURAL PRICES,
ETC., NOT TO MENTION A GENERALLY RELATIVELY HIGH COST
INDUSTRIAL SECTOR. HOWEVER, INFLATION ULTIMATELY HAS
TO BE FINANCED. SOMEBODY HAS TO PRINT THE MONEY. FOR
THE TIMEBEING THE AUTHORITIES HAVE CLEARLY INDICATED
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THAT THEY AREN'T ABOUT TO PRINT THE MONEY TO FINANCE
INFLATION. EVEN IF THIS POLICY HOLDS, THE GOF PROBABLY WON'T
ACHIEVE ITS 6 PERCENT INFLATION RATE OBJECTIVE BUT IT
ALMOST CERTAINLY WILL AVOID DOUBLE DIGIT INFLATION, AND
FOR 1976 THIS WILL PROBABLY BE SUFFICIENT TO DEFUSE THE
INFLATION HAZARD AT LEAST INsofar AS EXCHANGE RATE
POLICY IS CONCERNED.

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7. THE GOF ANTICIPATES A FAIRLY LARGE TRADE DEFICIT
IN 1976. IF ONE VIEWS WORLDWIDE ECONOMIC DEVELOPMENTS
FROM MID-1974 TO MID-1976, THE FRENCH EXTERNAL POSITION
THROUGH A PERIOD OF CONSIDERABLE TURMOIL PROBABLY WILL
EMERGE IN APPROXIMATE EQUILIBRIUM ON CURRENT ACCOUNT,
WITH A LARGE SURPLUS DURING THE FIRST HALF OF THE
BUSINESS CYCLE AND A LARGE DEFICIT DURING THE SECOND
HALF. THIS PUTS THINGS INPROPER ECONOMIC PERSPECTIVE
SINCE BUSINESS CYCLES HAVE A COMPELLING LOGIC ALL THEIR
OWN. FORTUNATELY OR UNFORTUNATELY EXCHANGE TRADERS
AND FOREIGN EXCHANGE MARKET OPERATORS ARE RARELY IF
EVER ECONOMISTS. THEY OFTEN FOCUS ON TRADE BALANCES,
PARTICULARLY ON LARGE CHANGES IN TRADE BALANCES. THEY
ARE VERY LIKELY TO SEE SUCH A CHANGE IN FRANCE IN 1976.
THE FRENCH AUTHORITIES HAVE ANTICIPATED THIS PROBLEM
AND PLAN TO COUNTER IT BY INDUCING CAPITAL INFLOWS.
THIS MEANS AMONG OTHER THINGS CONTINUATION OF THE
PRESENT POLICY OF RELATIVE CREDIT RESTRAINT AND
RELATIVELY HIGH INTEREST RATES. THIS PROBABLY CAN

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BE DONE IN 1976, PROVIDED FRENCH CORPORATE CASH FLOW
AND PROFITS TAKE A TURN FOR THE BETTER.

8. DURING THE FINFLATION OF THE PAST SEVERAL YEARS, FRENCH INDUSTRY HAS ADDED VERY SUBSTANTIALLY TO ITS DEBT, WHILE EQUITY CONTRIBUTIONS HAVE VIRTUALLY STAGNATED. FROM 1971 TO 1974 THE DEBT OF FRENCH ENTERPRISES, EXCLUDING HOUSING AND CONSTRUCTION FIRMS, ROSE FROM 331.1 BILLION FRANCS TO 519.3 BILLION FRANCS. FIGURES FOR 1975 ARE NOT AVAILABLE BUT THE INCREASE IS BELIEVED TO HAVE BEEN VERY SUBSTANTIAL, POSSIBLY AS HIGH AS 90 OR 100 BILLION FRANCS. THIS HAS HAD THE EFFECT OF INCREASING THE BREAK EVEN POINT OF FRENCH INDUSTRY GENERALLY. MOREOVER, LOAN RATES REMAIN RELATIVELY HIGH, REFLECTING CURRENT MONETARY POLICY. FRENCH INDUSTRY GENERALLY IS RELATIVELY HIGH COST, SO THE FINANCING BURDEN OF THIS VERY LARGE INCREASE IN DEBT AGAINST STEADY OR SLOW SALES GROWTH IS A MAJOR REASON FOR THE VERY SERIOUS CASH FLOW PROBLEMS OF FRENCH INDUSTRY. IT ALSO MEANS THAT FRENCH INDUSTRY GENERALLY CANNOT BE VERY PROFITABLE IF AT ALL AT CURRENT LEVELS OF CAPACITY UTILIZATION.

THE AUTHORITIES ARE KEENLY EVEN PAINFULLY AWARE OF THIS PROBLEM. IT REPRESENTS, IN FACT, THE GREATEST SINGLE THREAT, NOT ONLY TO EXCHANGE RATE POLICY, BUT TO OVERALL GOALS OF ECONOMIC POLICY AS WELL IN 1976. THEIR RESPONSE HAS BEEN TO ASSURE FRENCH FIRMS IN CASH FLOW DIFFICULTY THAT THEY WILL RECEIVE SPECIAL CREDITS. THIS AVOIDS THE WORST SHORT-TERM EFFECTS, E.G., CUTBACKS AND UNEMPLOYMENT; BUT IT HARDLY RESOLVES THE PROBLEM. ONLY A RETURN TO A RELATIVELY HIGH ECONOMIC GROWTH RATE WHICH WILL ALLOW FRENCH INDUSTRY TO OPERATE ABOVE ITS BREAK EVEN POINT WILL REALLY RESOLVE THIS PROBLEM. THERE IS THE THEORETICAL POSSIBILITY OF ACHIEVING IMPROVED CASH FLOW BY LIQUIDATING DEBT AND REAL ASSETS, BUT THIS ALSO LIQUIDATES JOBS AND PRODUCTION. CORPORATE CASH FLOW AND PROFITS REPRESENTS THE CRUX OF FRENCH ECONOMIC POLICY IN 1976. IT ALSO IS THE FUNDAMENTAL REASON FOR DOUBTS ABOUT LIMITED OFFICIAL USE

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THE CONTINUED RELATIVE STRENGTH OF THE FRENCH FRANC. IN EXCHANGE POLICY TERMS, IT POSES A DILEMMA BECAUSE A QUICK RETURN TO A HIGH GROWTH RATE WOULD ALMOST CERTAINLY REVIVE STRONG INFLATIONARY PRESSURES, THEREBY WEAKENING THE FRANC. HOWEVER, CONTINUED CORPORATE CASH FLOW AND PROFIT PROBLEMS, APART FROM OVERALL ECONOMIC EFFECTS, WILL CAUSE FRENCH INDUSTRY TO FAVOR A DEPRECIATING RATE TO INCREASE EXPORTS IN ORDER TO INCREASE CAPACITY UTILIZATION IN THE HOPES

OF EVENTUALLY IMPROVING PROFITS.

IN ANY EVENT THE EVOLUTION OF FRENCH CORPORATE CASH

FLOW AND PROFIT IN 1976 WILL HAVE A DECISIVE INFLUENCE
ON BOTH OVERALL ECONOMIC POLICY AND EXCHANGE RATE
POLICY. FOR THE TIMEBEING, THIS SITUATION SEEMS TO
HAVE STABILIZED IN THAT IT ISN'T WORSENING. BUSINESS
CONFIDENCE IS MUCH IMPROVED. WITH LUCH BY THE SECOND
HALF OF THIS YEAR CORPORATE CASH FLOW AND PROFITS MAY
SHOW SHGNS OF REAL IMPROVEMENT IF CURRENT FINAL DEMAND
FORECASTS ARE REALIZED. IF SO, THE AUTHORITIES WILL
BE ABLE TO IMPLEMENT THEIR EXCHANGE RATE POLICIES. IF
NOT, MORE THAN JUST EXCHANGE RATE POLICY WILL HAVE TO
CHANGE IN FRANCE.

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